CAPITAL GROUP® | AMERICAN FUNDS

Capital Group has focused on providing superior long-term results for American Funds® since 1931.

Fixed income focus

May 2018

Mike Gitlin
Head of Fixed Income

Kelly Campbell
Senior Investment Product Manager

Why fixed income? 4 roles your bond portfolio should play.

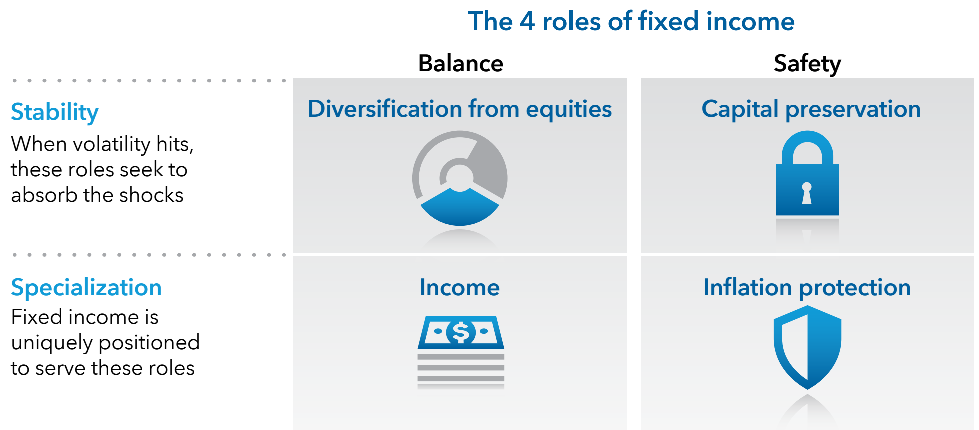
Fixed income serves four important roles in a portfolio: Diversification from equities, capital preservation, income and inflation protection. Many investors would benefit from evaluating whether their bond holdings are meeting these goals.

Each year, Capital Group meets with thousands of advisors to evaluate their clients' portfolios and offer our perspectives on potential enhancements. Common problems often surface. Some funds have too much risk embedded in bond allocations. Others develop high correlations to equities due to reaching for yield beyond what may be prudent.

In fact, according to Morningstar's best-fit index methodology, which uses a quantitative method to determine which index a fund most closely resembles, roughly 89% of the Short-Term Bond category behaves more like a credit index than a high-quality, short-term bond strategy.* Style drift like this, and others pitfalls, can be addressed by refocusing on the four roles that fixed income is designed to play in a portfolio.

What goals can fixed income achieve in your portfolio?

We believe bonds can serve four central roles in a balanced portfolio. These roles can aid in reaching retirement goals or simply stabilize a portfolio to be more resilient when economic shocks hit markets.



*Source: Morningstar. As of 3/31/2018.

Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so they may lose value.

1. Diversification from equities

Your bonds shouldn't behave like stocks when volatility hits.

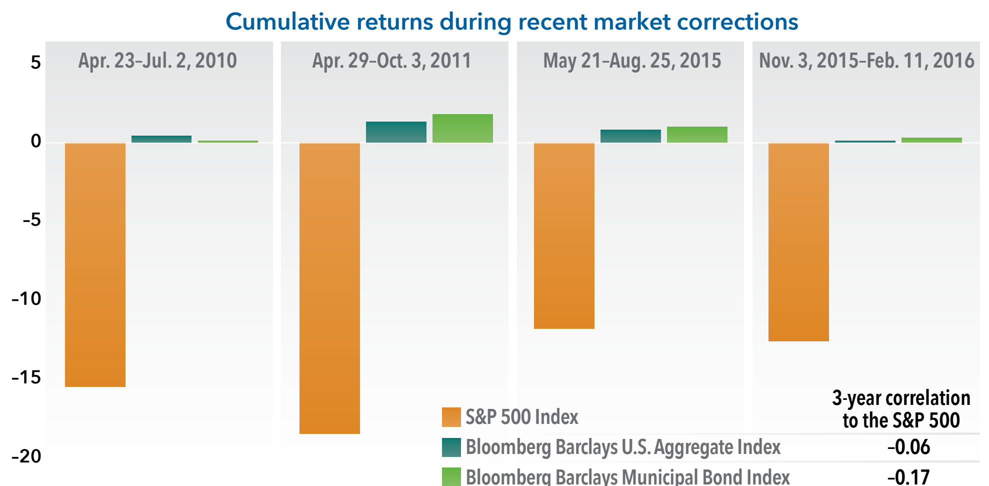
If the stock market always rose, then many investors might not bother with bonds. But unfortunately, equity markets often experience volatility and corrections. When this happens, it's important to have investments within a portfolio that are designed to provide resilience. That's the essence of why investors should seek balanced, diversified portfolios: When one part of a portfolio struggles, another part can pick up the slack.

"Many bond allocations today are not ideally positioned to weather a stock market decline."

Many bond allocations today are not ideally positioned to weather a stock market decline. They hold potential "hidden" risks in the form of high correlations between the fixed income and equity portions of the portfolio. For instance, they may hold funds with an outsized allocation to higher yielding bonds, which historically have had a high correlation to equities and tend to decline in value when stock markets decline. In contrast, fixed income sectors such as Treasuries and agency mortgage-backed securities tend to provide good diversification from equities.

For that reason, investors should seek to upgrade their portfolio with funds that provide diversification from equities. These can be good building blocks to dampen volatility and create durable portfolios. These strategies often have a low correlation to equities because they invest in higher quality bonds that tend to hold up well when stocks suffer losses. This stability can help enable an investor to rebalance when equities are priced more attractively and to take advantage of market cycles. This approach can help investors achieve long-term investment and savings goals.

Fixed income strategies aiming for diversification can cushion equity volatility



Data as of March 31, 2018. Sources: Bloomberg Index Services, Ltd., Morningstar.

Dates shown for market corrections are based on price declines of 10% or more (without dividends reinvested) in the unmanaged S&P 500 with 50% recovery between declines. The returns of the indexes are based on total returns.

2. Capital preservation

A durable portfolio needs a strong foundation.

If equities decline sharply, and a portfolio only contains equities, the portfolio could lose a substantial amount of capital. That's a particularly serious situation for investors who are nearing retirement. This reveals another important role of fixed income: to help preserve capital.

"Unlike equities, high-quality fixed income securities can serve as an all-weather foundation for a portfolio."

Unlike equities, high-quality fixed income securities can serve as an all-weather foundation for a portfolio. This can be seen by looking at even medium-term rolling returns for bonds or bond funds with capital preservation as their chief objective. Even if losses occur over short-term time horizons, over medium- and long-term periods, high-quality fixed income investments have historically had a very strong track record of protecting capital, and short-term periods of losses have tended to be minor in comparison to declines in equities or bond sectors like high yield.

Bonds issued or guaranteed by stable governments or corporations with good business models and solid balance sheets are key building blocks for a capital preservation strategy. Bonds structured to be backed by strong collateral can also achieve very high quality. Many of these securities have credit ratings at the upper end of the investment-grade spectrum. That said, ratings are only one of many metrics we use to establish the capital preservation aspect of securities. The more risk-averse an investor, the larger the capital preservation component of their portfolio is likely to be.

High-quality bonds have demonstrated strong capital preservation

Positive three-year rolling return, over 20 years

Bloomberg Barclays U.S. Government/Credit (1-7 years, ex BBB) Index

Bloomberg Barclays Municipal Short-Intermediate 1-10 Years Index

Over 20 years through 12/31/2017. Source: Bloomberg Index Services, Ltd.

3. Income

It's called fixed *income* for a reason.

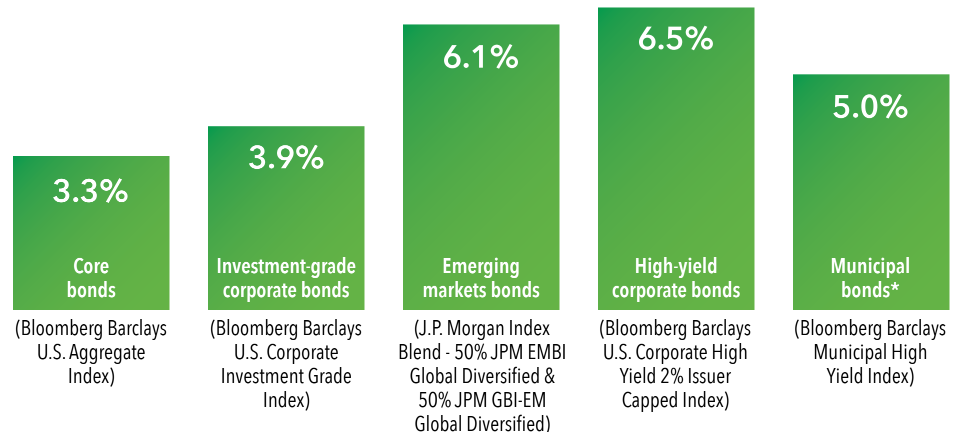
Another way fixed income fundamentally differs from equity is its explicit income component. Although some common and preferred stocks pay dividends, these income streams can fluctuate or disappear at a company's discretion. Bonds carry more explicit and predictable income streams in the form of coupons, so long as the issuer remains solvent. The yield will fluctuate with the price.

"Years of rock-bottom interest rates have resulted in some 'scope creep' in select bond funds that are now holding riskier bonds to augment their yield."

For this reason, bond funds typically provide some income, with higher yielding bonds generally associated with additional risk. However, years of rock-bottom interest rates have resulted in some "scope creep" in select bond funds that are now holding riskier bonds to augment their yield. This is especially prevalent in some of the top-performing funds, even in groups that have traditionally focused on capital preservation, as mentioned earlier in regard to Morningstar's Short Term Bond category.

In today's market environment of stretched credit valuations, caution is advisable. Investors may potentially take on too much equity-like risk by allowing high-yield corporates to dominate their bond allocations.

Average yield-to-maturity of selected income-driven benchmark indices



As of April 30, 2018. Sources: Bloomberg Index Services, Ltd., J.P. Morgan.

*Yield for this index represents a yield-to-worst, as Bloomberg Barclays does not provide a yield-to-maturity for its municipal indices. The tax-equivalent yield-to-worst was 8.5%, which assumes the top federal marginal tax rate for 2018 of 37%, plus the 3.8% Medicare tax.

4. Inflation protection

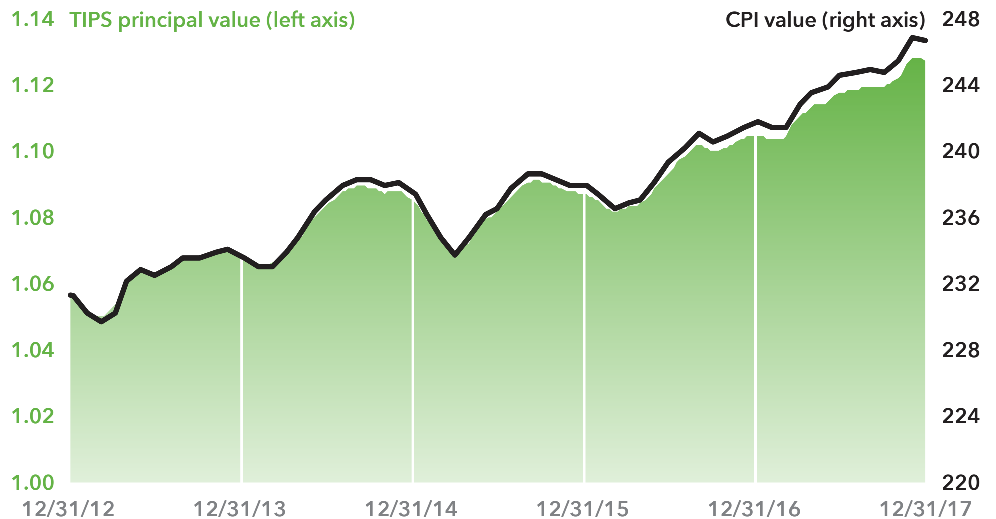
Inflation is rising. Is your portfolio ready?

Over the past several years, relatively low inflation has pushed this risk from the front of many investors' minds. However, economic growth has remained strong and finally seems to be boosting wages. That and other factors are pushing inflation higher. As 2018 began, we saw year-over-year wage growth hit an eight-year high. Inflation, as measured by the Consumer Price Index (CPI), has risen to above 2% year-over-year. It could rise further as the economy remains robust and the Federal Reserve remains cautious. However, even if inflation merely remains stuck at the Federal Reserve's modest 2% target for a decade, that reduces a portfolio's purchasing power by 18% over that 10-year period.

"While a number of investment vehicles can provide indirect protection against inflation, an inflation-linked bond fund can more explicitly preserve purchasing power."

While a number of investment vehicles can provide indirect protection against inflation, an inflation-linked bond fund can more explicitly preserve purchasing power. This can be achieved by owning funds that invest in bonds whose valuations have an explicit link to the CPI, such as Treasury Inflation-Protected Securities (TIPS). The principal value of TIPS adjusts with changes in CPI so that as inflation rises, the principal value increases to preserve purchasing power. Inflation-linked funds can provide more precise protection for purchasing power, especially when inflation surprises to the upside.

Treasury Inflation-Protected Securities (TIPS) have moved in near lock-step with the Consumer Price Index (CPI)



Source: Thomson Reuters, as of December 31, 2017.

The bottom line

"Investors who seek a balanced portfolio should ensure that their fixed income allocation serves these four roles."

For long-term investing, balance is key. Investors who seek a balanced portfolio should ensure that their fixed income allocation serves these four roles. Now may be a good time for investors to run a checkup on their fixed income portfolios and consider making the following adjustments:

- **Upgrade** core bond portfolios to help provide better **diversification from equities** when it's needed most – when stocks struggle.
- **Maintain** an allocation to very high-quality bond funds that seek **capital preservation** in order to help provide a cushion for losses in riskier assets.
- **Seek** diversified sources of **income** and consider strategies like emerging market debt or high-income municipal bond strategies, rather than relying only on high-yield corporate bonds.
- **Buy inflation protection** in case consumer prices rise faster than expected.

While interest rates remain relatively low, it may be tempting to reach for yield. But with uncertainties ahead, from central bank tightening to potential geopolitical volatility, building bond allocations with a true core foundation can help fulfill these four important roles and can lead to better long-term outcomes.

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing.

Past results are not predictive of results in future periods.

Content contained herein is not intended to serve as impartial investment or fiduciary advice. The content has been developed by Capital Group which receives fees for managing, distributing and/or servicing its investments.

The statements expressed herein are opinions of the individuals identified, are as of the date published, and do not reflect the opinions of Capital Group or its affiliates. Any reproduction, modification, distribution, transmission or republication of the content, in part or in full, is prohibited.

Bloomberg Barclays U.S. Aggregate Index represents the U.S. investment-grade fixed-rate bond market.

Bloomberg Barclays Municipal Bond Index is a market-value-weighted index designed to represent the long-term investment-grade tax-exempt bond market.

Bloomberg Barclays U.S. Government/Credit 1-7 Years ex BBB Index is a market-value weighted index that tracks the total return results of fixed rate, publicly placed, dollar-denominated obligations issued by the U.S. Treasury, U.S. government agencies, quasi-federal corporations, corporate or foreign debt guaranteed by the U.S. government, and U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity and quality requirements, with maturities of one to seven years, excluding BBB-rated securities

Bloomberg Barclays Municipal Short-Intermediate 1-10 Years Index is a market-value-weighted index that includes investment-grade tax-exempt bonds with maturities of one to 10 years.

Bloomberg Barclays U.S. Corporate Investment Grade Index represents the universe of investment grade, publically issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index covers the universe of fixed-rate, non-investment-grade debt. The index limits the maximum exposure of any one issuer to 2%.

Bloomberg Barclays High Yield Municipal Bond Index is a market-value-weighted index composed of municipal bonds rated below BBB/Baa.

These indexes are unmanaged, and their results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes.

Bloomberg® is a trademark of Bloomberg Finance L.P. (collectively with its affiliates, "Bloomberg"). Barclays® is a trademark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Neither Bloomberg nor Barclays approves or endorses this material, guarantees the accuracy or completeness of any information herein and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

Securities offered through American Funds Distributors, Inc.

Lit. No. MFGEOS-130-0518O CGD/AFD/10174S68571 © 2018 Capital Group. All rights reserved.